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Investing Trust Fund Assets in the Employer's Own Stock: Some Prophylactic Considerations

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INVESTING TRUST FUND ASSETS IN THE EMPLOYER'S OWN STOCK: SOME PROPHYLACTIC CONSIDERATIONS

George E. Long*

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I. INTRODUCTION

Increasing public attention has focused on the rapid growth of trust funds held to secure benefits promised under employee benefit plans. Many trust funds maintained by an employer for the benefit of employees equal or exceed the net worth of the employer; many other employee trust funds are fast approaching that status. These enormous sums have attracted the attention of professional money managers—banks, trust companies, investment counsellors, mutual fund managers, and, of course, insurance companies. Competition for the management of these trust funds has directed employer attention to the areas of money manager selection, investment performance, and money management capabilities. Many employers, however, are unwilling to abdicate their responsibility to their employees by contributing money to trust funds whose complete investment responsibility is in the hands of traditional money managers.

Some employers have created their own "captive" investment counselors by having their directors, officers, or other specially-trained employees make investment decisions for part or all of their employee benefit trust funds. Since "captive" investment counsellors often decide that the best investment of at least part of the trust funds is in employer stock, notes, or other property, many questions arise concerning potential problems with regard to self-dealing, prudence, and permissibility. Investment counsellors

soon discover that rules restricting investments in stock and other property of the employer have kept pace with the growth of trust funds. The Internal Revenue Service requires detailed disclosure and strict compliance with their rules in all transactions of this type. The onerous task of explaining the transaction to the Internal Revenue Service may be enough to prompt many employers to forego investment in employer stock with trust funds. Each year more stringent rules governing such investments are either enacted by Congress or promulgated by the Internal Revenue Service. Notwithstanding the strict investment and disclosure rules, many employers and their investment counsellors are convinced that investment of employee benefit plan trust funds in the employer's stock, promissory notes, or other property is in the best interests of both the employees and the employer. This article explores the prophylactic considerations regarding such investments.

II. GENERALLY

Section 401(a) of the Internal Revenue Code of 1954 (hereinafter referred to as the Code) sets forth the requirements for "qualified" pension, profit-sharing, and stock bonus plans.¹ The trustees of these plans may purchase any investments which are permitted by the trust agreement to the extent allowed by local law.² No part of the corpus or income may be used for, or diverted to, purposes other than the exclusive benefit of the employees or their beneficiaries.³ The trust funds should be invested with a high degree of diligence with fiduciary restraint. Care is required to preserve the safety of the principal while maintaining the highest return consistent with such safety. As long as investments are made pursuant to the foregoing general principles, and the employer⁴ and/or its securities and property

1. Briefly, a qualified employee benefit plan is a definite written program providing a funded plan of deferred compensation for employees which is established and maintained by an employer on a permanent basis. It must meet four basic requirements. It must (a) be communicated to the employees, (b) have a valid existing trust, (c) not discriminate in contributions or benefits or in coverage in favor of officers, shareholders, supervisors or highly compensated employees, and (d) be for the exclusive benefit of employees or their beneficiaries. If a pension plan, it must provide systematically for the payment of definitely determinable benefits to employees over a period of years, usually for life, after retirement. If a profit sharing plan, or a stock bonus plan, it enables employees to share in the employer's profits pursuant to a definite formula for allocating contributions made to the plan and for distributing the funds accumulated under the plan. 26 C.F.R. § 1.401-1(a) (Supp. 1971).

2. 26 C.F.R. § 1.401-1(b)(5)(i) (Supp. 1971); Rev. Rul. 69-421, 1969-2 CUM. BULL. 59; Rev. Rul. 69-494, 1969-2 CUM. BULL. 88.

3. INT. REV. CODE OF 1954, § 401(a)(2).

4. The company creating the trust, or its controlled corporation. INT. REV. CODE OF 1954, § 503(b).

are not involved in the transaction, the Internal Revenue Service exhibits little concern.⁵

It is permissible to invest in the property or securities of the employer, or to loan trust funds to it, if all pertinent rules are followed. The trust can lose its tax exempt status,⁶ however, if such an investment is determined by the Internal Revenue Service to constitute a "prohibited transaction,"⁷ or to violate the exclusive benefit rule.⁸

III. INVESTMENTS INVOLVING THE EMPLOYER

A. *Disclosure and Procedure.*

1. *Disclosure and effect of losing tax exempt status.* If trust funds are invested in the property or securities of, or loaned to, the employer, the trustee must fully disclose to the Internal Revenue Service the reasons for the investments and the conditions under which they are made. This disclosure must be made on the trust's annual information return, whether or not an advance determination letter is sought.⁹

As a practical matter, no trust funds should be invested in the securities or other property of the employer, or loaned to it, without the issuance of a favorable advance determination letter by the Internal Revenue Service. If an advance determination is not obtained, the investment may be found to be a prohibited transaction or to violate the exclusive benefit rule, and the trust may lose its exempt status for at least one year¹⁰ as well as incur other possible penalties.¹¹

Losing tax exempt status has a more adverse tax effect on employees than on the employer because of the 1969 Tax Reform Act. Prior to the Act, the employer could lose its tax deduction for one year's contribution. Under the 1969 Act, the employer receives a deduction when the employee is taxed.¹² The employee

5. However, the trust could be subject to tax with respect to any "unrelated business taxable income" realized from investments. INT. REV. CODE of 1954, § 511. See also note 2, *supra*.

6. INT. REV. CODE of 1954, § 503(G); 26 C.F.R. § 1.401-1(b)(5)(i) (Supp. 1971).

7. INT. REV. CODE of 1954, § 503(b); see also Rev. Rul. 69-421, 1969-2 CUM. BULL. 59.

8. INT. REV. CODE of 1954, § 401(a)(2).

9. 26 C.F.R. § 1.401-1(b)(5)(ii) (Supp. 1971). This return is on Form 990P.

10. INT. REV. CODE of 1954, § 503(c); Rev. Proc. 72-6, § 8.08, INT. REV. BULL. No. 2, at 22.

11. In some situations it is not possible to obtain a favorable advance determination letter; extreme care should be taken to comply with all the rules in those situations.

12. This deduction depends upon maintenance of separate employee accounts. INT. REV. CODE of 1954, § 404(a)(5).

will be taxed currently on nonforfeitable contributions to a non-exempt plan, or can elect to be taxed currently on forfeitable contributions to a nonexempt plan.¹³ The principal losers, however, are those employees who retire or leave and receive distributions during the period the trust is not exempt. Those employees will lose the tax advantages allowable for capital gain treatment of lump sum distributions as well as the favorable forward averaging treatment for any ordinary income element.

2. *Procedure for obtaining I.R.S. approval.* The District Director of Internal Revenue will issue advance determination letters as to the effect of proposed investments in employer securities (including secured notes) on the continuing qualification of the plan under Code Section 401(a).¹⁴ The trustee's request for such an advance determination letter should be accompanied by certified financial information regarding the employer.¹⁵ A special form is used for this purpose.¹⁶ If all the Internal Revenue Service requirements are met, a favorable determination will be issued. If the District Director intends to issue an unfavorable determination he will normally notify the taxpayer, and the taxpayer can request referral to the National Office in Washington for technical advice.¹⁷ The taxpayer may also request referral to the National Office if the District Director refuses to issue either a favorable or an unfavorable determination.¹⁸ The District Director will not, however, issue an advance determination letter upon the question of the fair market value of the property or the adequacy of security.¹⁹

In determining whether such an investment is consistent with the requirement that the plan be for the exclusive benefit of the employees or their beneficiaries, the District Director is to be guided by the following rules:²⁰ The cost of the investment must not exceed the "fair market value"; a "fair return" must be provided; "liquidity" must be maintained; and the "safeguards," including diversity to which a prudent investor would adhere must exist. Some of the considerations with respect to these rules are set forth below in connection with specific types of investments.

13. INT. REV. CODE OF 1954, §§ 83, 402(b).

14. Rev. Proc. 72-6, § 3.01(b), 1972 INT. REV. BULL. No. 1, at 20. See also note 19, *infra*.

15. Rev. Proc. 72-6, § 4.03, 1972 INT. REV. BULL. No. 1, at 21.

16. *Id.*

17. Rev. Proc. 72-6, § 7, 1972 INT. REV. BULL. No. 1, at 22; Rev. Proc. 72-2, § 4, 1972 INT. REV. BULL. No. 1, at 6.

18. Rev. Proc. 72-6, § 7, 1972 INT. REV. BULL. No. 1, at 22; Rev. Proc. 72-2, § 4, 1972 INT. REV. BULL. No. 1, at 6.

19. Rev. Proc. 72-6, § 3.02, 1972 INT. REV. BULL. No. 1, at 20. See text accompanying notes 21 and 43, *infra*.

20. Rev. Rul. 69-421, 1969-2 CUM. BULL. 59.

B. *Specific Types of Investments.*

1. *Stock of the Employer.* Probably the most common type of investment involving the employer is in its own stock. The following criteria should be considered with respect to compliance with the Internal Revenue Service rules for this type of investment.

a. *"Fair Market Value"*

(1) *Compliance with the rules.* The I.R.S. usually determines, at the time the applicable information returns of the trust are examined, whether the requirement that the cost of the stock to the trust fund must not exceed the fair market value at the time of purchase has been met. The District Director will not specifically pass upon the question of valuation in an advance determination letter,²¹ nor will the National Office rule upon the question.²²

(2) *Methods of compliance.* In determining the fair market value of the stock purchased by the trust fund, a method must be followed which will protect the tax-exempt status of the trust when its information returns are examined. If stock is purchased directly from the employer, care should be taken that all dealings are at arm's length and on a fair and equitable basis. Fair market value at the time of the transaction is determinative. In the case of listed stock or stock traded on the open market or a recognized exchange, the quoted price ordinarily represents the fair market value. In the case of stock which is not listed, or stock not traded on the open market or a recognized exchange, it may be necessary, or at least advisable, to have an independent qualified appraisal made. In determining fair market value, the appraisers should take into consideration the value of the underlying corporate assets, earning capacity, the conditions of the business and other factors.²³

b. *"Fair Return"*

(1) *Compliance with the rules.* The District Director, either in an advance determination letter, if requested, or upon examination of the information returns of the trust, will determine whether a fair return commensurate with the prevailing rate of return will be provided by the trust fund. The I.R.S. has ruled that

21. Rev. Proc. 72-6, § 3.02, 1972 INT. REV. BULL. No. 1, at 20.

22. Rev. Proc. 72-6, § 8, 1972 INT. REV. BULL. No. 1, at 23.

23. 26 C.F.R. § 20.2031-2 (Supp. 1971); Rev. Rul. 59-60, 1959-1 CUM. BULL. 237; Rev. Rul. 65-193, 1965-2 CUM. BULL. 370; Rev. Rul. 68-609, 1968-2 CUM. BULL. 327.

this "fair return" requirement is not applicable to an obligatory investment made in the stock of the employer by the trustee of a stock bonus plan.²⁴

(2) *Methods of compliance.* If the stock has a good record and a history of dividend payments, the fair return requirement is met. In some cases Internal Revenue Service agents take the position that unless there is a good dividend history both in consistency and amount, they will not issue a favorable advance determination.²⁵ Others take the more enlightened position that even if such record and history of return is not good, under certain circumstances the "fair return" requirement can be met.²⁶ It is not uncommon for a growth company, whether or not closely held, to reinvest its earnings for expansion, rather than pay dividends. If it can be shown that the earnings record and increase in earned surplus have been good, some offices of the District Director will be disposed to rule favorably.²⁷

c. "*Liquidity*"

(1) *Compliance with the rules.* Sufficient liquidity should be maintained when employer stock is purchased by the trust fund to permit distributions in accordance with the stated purposes of the plan. Compliance with this requirement is determined by the District Director either in an advance determination letter or upon audit of the information returns of the trust. Of course, all assets of a stock bonus plan are invested in employer stock, and distribution should be made in kind.²⁸

(2) *Methods of compliance.* If there is a ready market in which to dispose of the stock if it becomes necessary, the liquidity requirement will probably be met. For unlisted stock in which there is no over-the-counter trading, the requirement may be more difficult to satisfy; however, several methods seem to be available. When the amount to be invested in employer stock will not be needed for distribution to employees for a few years, a growing

24. This is because the object of such a plan is to give the employee—participants an interest in the ownership and growth of the employer's business. Rev. Rul. 69-65, 1969-1 CUM. BULL. 114.

25. This is based on the author's own experience.

26. *Id.*

27. As a hypothetical example, consider the performance of International Business Machines over the last twenty-five years, or more recently Xerox Corporation, or the large pharmaceutical companies. An Internal Revenue agent who might have turned down a request for investment in company stock some years ago because of low dividend rates would certainly have done the employees a disservice.

28. Rev. Rul. 69-65, 1969-1 CUM. BULL. 114. See also Rev. Rul. 71-256, 1971 INT. REV. BULL. No. 24, at 33. See text section IV, *infra*, for detailed discussion of distributions in kind.

company may speculate on the probability of more active trading and a better market in its stock in future years. If the percentage of total trust funds invested in such stock is not too high, the company may demonstrate that the remainder of the assets of the trust fund will be able to meet all cash distributions to employees which are reasonably anticipated for several years to come until the growth potential is realized. This may be done by making an actuarial "pay out" protection study based on the ages of the employees.

In addition to the requirement of a ready market for the stock, the established policy of the Internal Revenue Service requires unrestricted marketability with respect to stock or securities of the employer corporation in which the trust fund is invested.²⁹ This policy prevents investment in stock which is issued subject to the right of the employer to repurchase it or to have the right of first refusal on subsequent disposition.

Implementing the liquidity requirement requires a different approach when dealing with a pension plan than when a profit-sharing plan is involved.

(a) *Pension Plans.* A "payout" projection study to determine the expected cash needed for distributions to employees is often made by the pension plan's actuaries upon the request of a trustee, as an aid in his determination of investment policy. Some actuaries make such a study at periodic intervals as a part of the actuarial valuation.

A random review of plans³⁰ gives the distinct impression that employer stock is used less often as an investment for pension funds than for profit-sharing funds. One reason might be that in order to maintain the plan for the "exclusive benefit of employees or their beneficiaries,"³¹ any resulting improvement in investment performance in a fixed benefit pension plan reduces the cost of the plan to the employer; thus, the employer may find it difficult to show that there is as much benefit to employees as to himself.

However, it has been argued that one distinct advantage of investing in employer securities in a pension plan is that it is expected that employer securities will perform better than the securities they replace or that would otherwise be purchased. If better performance in fact occurs, the pension cost to the employ-

29. Rev. Rul. 57-372, 1957-2 CUM. BULL. 256.

30. A sampling of the approximately 3000 plans prepared by the author supports this impression.

31. INT. REV. CODE of 1954, § 401(a).

er will be reduced. However, if the improved performance is primarily in market appreciation, current rates of contribution would not be reduced unless some method other than cost or market is used to value the assets. Most actuaries value assets at cost plus some increment to account for unrealized appreciation. This enables the employer to increase the fixed benefits under the pension plan periodically, thus eventually benefiting the employees covered. It may be possible to convince some Internal Revenue Service agents that because this also permits the employer to reach a position of full funding and greater security for the employees at an accelerated pace it is for the exclusive benefit of the employees.³²

Another consideration in pension plans is the possible effect of investment in employer securities if it should be necessary to terminate the plan due to the employer's inability to pay the required contribution. In such a situation the market value of employer securities is likely to be depressed. If the market value determines the future benefits to be paid, those benefits will be less than if no employer stocks had been purchased.

(b) *Profit-Sharing Plans.* A "pay out" protection study is somewhat more reliable in a pension plan than in a profit-sharing plan. This is due to the nature of the fixed and determinable benefits provided under a pension plan. However, pay out projections are still quite feasible for profit-sharing plans when modern consulting and actuarial techniques are applied.

In contrast to pension plans, employer securities are used extensively in many profit-sharing plans where any improvement in investment performance is directly reflected in the value of employee accounts, and where distributions in the form of employer stock receive favored tax treatment.³³

Many profit-sharing plans contain an avowed statement of purpose to accumulate capital for employees in the form of employer stock, so that the employees may extend their ownership in such stock. A provision will often be included that distributions should be made in employer stock when, and to the extent, possible. Such a provision aids in the task of complying with the liquidity rule in a profit-sharing plan. Where employees already hold a considerable amount of stock, the position of liquidity is strengthened.

32. This has been the author's experience.

33. One example of such favored treatment is lump sum distributions. 26 C.F.R. § 1.402(a) (Supp. 1971).

d. "Safeguards"

(1) *Compliance with the rules.* When employer stock is purchased by the trust fund, the existence of those safeguards for which a prudent investor would look when purchasing stock is also determined by the District Director, either in an advance determination or subsequent audit of the trust's information returns. The principal problem here is determining what percentage of a trust fund may be invested in employer stock. This is quite closely tied in with the liquidity requisite. Recent legislative proposals, such as the Administration's proposal embodied in S. 3024 introduced in the Senate by Senator Javits on December 14, 1971, would place an upper limit, such as ten percent, on the amount of a pension fund which can be invested in employer stock.³⁴ Senator Javits' bill, entitled "Employee Benefits Protection Act," is presently under consideration by the Committee on Labor and Public Welfare. Again, it should be noted that a stock bonus plan is designed to be entirely invested in employer stock.

(2) *Methods of compliance.* The requirement of "safeguards" is difficult to define. Apparently the requirement should be met whenever less than the total trust fund is invested in employer stock and the employer is a well-established concern which has no foreseeable prospects of financial hardship. The percentage limit of such an investment will vary with the circumstances of each employer and each trust fund.

The "safeguards" requirement emphasizes investment performance which depends upon financial strength, competitive strength, and favorable growth prospects. Although management has all the facts available to it to ascertain whether its employer stock meets these characteristics, it is advisable for management to bring in outside help to aid in this examination in order to ensure objectivity.

Investment performance will also affect the length of time for which a stock is held. Stability is a proper goal for investment, and it is sensible to invest with some degree of permanency in leading companies of stable industries. However, the "performance" cult of money managers considers it just as important to be willing to sell a stock as soon as the company outlook changes. Investment in the employer's own stock seldom, if ever, conforms to the "performance" requirements of these money managers, because employers are unwilling to unload their own stock

34. See also H.R. 1269, 92nd Cong., 1st Sess. (1971); H.R. 2150, 92nd Cong., 1st Sess. (1971); H.R. 5209, 92nd Cong., 1st Sess. (1971); H.R. 7193, 92nd Cong., 1st Sess. (1971); H.R. 7525, 92nd Cong., 1st Sess. (1971).

as their fortunes fluctuate. However, the question of future willingness to sell employer stock should be considered before investing in it.

In the area of "safeguards," as in liquidity, the considerations with respect to pension plans differ from those applicable to profit-sharing plans.

(a) *Pension Plans.* The question of how much of a pension fund can prudently be invested in company stock is difficult to answer objectively. When the employer intends to invest more than five or ten percent of the pension trust fund in employer stock, he must support his decision with adequate reasons. The best argument to support such an investment is that because of management's unique knowledge of its own company's prospects, it can better invest in its own stock than the stock of some other company about which it has no inside knowledge. This knowledge may justify bending the rules regarding diversification of investing heavily in employer stock.

(b) *Profit-Sharing Plans.* An investment of more than five or ten percent of a profit-sharing trust fund in employer stock is easier to justify. The profit-sharing plan and trust ordinarily should contain a provision directing that, to the extent deemed practicable and advisable by the trustee or an investment committee, the trust fund ought to be invested in employer stock to the end that employees may share in the earnings and growth of the employer.

Some profit-sharing plans (and some "money purchase" pension plans) divide their trust assets into two separate funds, with one fund to be invested as a diversified fund and the other in employer stock. Each participant is given a yearly election as to how much of his account he desires invested in each fund. Another form of individual account plan permits each participant to direct that all or any part of his account invested in employer stock be held and earmarked for him.³⁵

2. *Loans to the Employer.* Another common trust investment is in loans to the employer secured by notes. Prior to the changes made by the Internal Revenue Code of 1954, some loans were evidenced only by unsecured notes. With the inclusion of the "prohibited transactions" Section 503(c) in the Internal Revenue Code of 1954,³⁶ it is clear that investments in unsecured loans to the employer are possible only under very limited condi-

35. Rev. Rul. 69-421, 1969-2 CUM. BULL. 59.

36. INT. REV. CODE OF 1954, § 503(b); Rev. Rul. 69-421, 1969-2 CUM. BULL. 59.

tions,³⁷ which are not applicable to most employers. It has been argued that it is better for a trust to be a creditor of the employer than a stockholder of the employer. The Internal Revenue Service, however, has not been persuaded to change its rules. Accordingly, any loans to the employer should be collaterally secured by "adequate security"³⁸ and carry a reasonable rate of interest,³⁹ unless the loans are in the special categories of exempted loans established in the Code.⁴⁰

The secured loan, or a loan and mortgage transaction, can be an attractive arrangement for the trust and for the employer without violating the rule that investments be made for the exclusive benefit of the employees and beneficiaries. The following criteria must be considered to comply with the rules when a trust loans money to the employer.

(a) "*Fair market value.*" Compliance with the "fair market value" rule in loan transactions is usually determined by the District Director upon examination of the applicable information returns of the trust. Evidence of compliance is the face value of a promissory note which is collaterally secured, or the independent market value of debenture bonds or notes.

(b) "*Fair return.*" Compliance with the "fair return" requisite in loan transactions is determined by the District Director either in an advance determination letter if requested, or upon examination of the information returns of the trust. As stated in the regulations explaining Code Section 503(b)(1),⁴¹ the requirement that a loan must bear a "reasonable rate of interest" is determined by comparing the interest return on the loan with the prevailing rate of interest charged for a similarly secured loan of the same duration by financial institutions in the community where the transaction takes place.⁴²

(c) "*Liquidity.*" Compliance with the "liquidity" requisite when loans are made by the trust to the employer is also determined by the District Director, either in advance if a request is filed, or upon audit of the trust's information returns. Here again, an actuarial "pay-out" projection study may help to prove compliance if it shows that the amount invested in the loan is not needed to make payments which are currently due to participants.

(d) "*Safeguards.*" A favorable determination of compli-

37. INT. REV. CODE of 1954, § 503(e), (f).

38. 26 C.F.R. § 1.503(c) (Supp. 1971). See also Rev. Rul. 66-324, 1966-2 CUM. BULL. 230; Rev. Rul. 70-131, 1970-1 CUM. BULL. 135.

39. Rev. Rul. 71-311, 1971 INT. REV. BULL. No. 29, at 86.

40. INT. REV. CODE of 1954, §§ 503(e), (f).

41. 26 C.F.R. § 1.503(b) (Supp. 1971).

42. 26 C.F.R. § 1.503(c) (Supp. 1971).

ance with the "safeguards" requisite in loan transactions apparently depends upon whether there is "adequate security."⁴³ The District Director does not give advance determination letters on this question, but an advance ruling from the National Office may be requested in certain situations. If an advance ruling is not sought or obtained from the National Office, compliance will be determined by the District Director upon audit of the trust's information returns.

The National Office will give an advance ruling in respect to adequate security in cases involving loans to the employer (including notes and debentures) if the security is clearly adequate and can be established without requiring valuation or appraisals.⁴⁴ However, even if a particular transaction fails to meet the applicable requirements for obtaining an advance ruling, it need not necessarily cause the trust to lose its exempt status. For instance, where a mortgage on realty is security for a loan to the employer, the loan should not be in excess of 50% of the real property's assessed value for local tax purposes, if an advance ruling is desired before making the loan.⁴⁵ However, it is submitted it should be possible to make such a secured loan even though it is impossible to obtain an advance determination because the loan is in excess of the 50% value. Assessments for local tax purposes will, of course, vary by location and practice, but as long as the realty's actual fair market value demonstrates such value that it may reasonably be anticipated that no loss will result, no adverse determination should be made upon audit of the trust's information returns. Note that it has been held that a union may borrow from a union-negotiated, jointly administered pension trust covering its members (giving a second mortgage on its union headquarters building) because it is neither the creator of the trust, a substantial contributor, nor a corporation controlled by a creator.⁴⁶

3. *Sale-and-Lease-Back.* Sale-and-lease-back real estate investments have been popular with qualified trusts. Such an investment may be beneficial both to the trust and to the employer under appropriate conditions. Those conditions, however, must be carefully evaluated because the trust purchases real estate and leases it back to the seller-employer on a long-term basis, the advisability of the investment depends to a great extent upon the long term success of the seller-employer. The advantages to the

43. 26 C.F.R. § 1.503(c) (Supp. 1971); Rev. Rul. 66-324, 1966-2 CUM. BULL. 230; Rev. Rul. 70-131, 1970-1 CUM. BULL. 135.

44. Rev. Proc. 72-6, § 8, 1972 INT. REV. BULL. No. 1, at 23.

45. *Id.*

46. Rev. Rul. 71-462, 1971 INT. REV. BULL. No. 42, at 17.

employer may quickly disappear if the employer is subject to cyclical changes in demand and starts to lose money, in which case the arrangement may impose a severe drain on working capital.⁴⁷ The following are considerations with respect to compliance with the present Internal Revenue Service rules in the case of a sale-and-lease-back.

(a) "*Fair market value*" The District Director does not issue advance determinations involving sales-and-lease-backs, and presently it does not appear possible to obtain an advance ruling from the National Office concerning the fair market value of the property involved.⁴⁸ Accordingly, careful consideration should be given to all the facts and circumstances to prevent a retroactive or future disqualification of the plan and trust upon subsequent examination of the trust's information returns. To evidence compliance with this "fair market value" requisite, a file should be gathered to prove the fairness of the purchase price and rental to be charged. Appraisals and bona fide offers from third parties should be obtained, anticipating audit of the information returns.

(b) "*Fair return*" Because the question of a "fair return" in sales-and-lease-backs depends in part upon the determination of the fair market value of the property involved, compliance will be determined only upon audit of the trust's information returns. Again, independent appraisals may be desirable. Additionally the lease-back should not produce an excessively large return to the trust or the employer runs the risk of losing his tax deductions on excess rentals paid to the trust under the lease-back.⁴⁹

(c) "*Liquidity*" An actuarial "pay out" projection study may serve as evidence of compliance with the "liquidity" requisite in a sale-and-lease-back arrangement.

(d) "*Safeguards*" To comply with the "safeguards" requirement, it would seem advisable to limit amounts involved in sale-and-lease-back transactions to a reasonable portion of the total trust fund, especially where the property is unique to the employer's operations. Another reason for restricting the portion of the trust fund to be involved in the transaction is that if the trust becomes indebted as a result of borrowing money to purchase or improve the property, the rental will produce unrelated taxable business income for the trust.⁵⁰ Such unrelated income will be

47. Senate bill S. 3024, the "Employee Benefits Protection Act," which is presently under consideration by Congress, would prohibit sale-and-lease-back transactions with the employer.

48. Rev. Proc. 72-6, § 8, 1972 INT. REV. BULL. No. 1, at 23.

49. Rev. Rul. 71-311, 1971 INT. REV. BULL. No. 29, at 86.

50. INT. REV. CODE of 1954, §§ 511(a)(2)(A), 511(b)(1).

taxable in the proportion which the indebtedness bears to the adjusted basis of the property.⁵¹

IV. CONTRIBUTIONS IN KIND

Employer contributions to a qualified plan are normally made in cash, but may also be made in real estate, stock of the employer, or promissory notes. These methods of contribution are often used by employers who desire to conserve working capital or for other business reasons. One reason may be that the rules governing contributions in kind seem to favor form over substance. For example, there seems to be no specific prohibition precluding an employer from contributing employer stock to the trust fund without approval of any kind from the Internal Revenue Service. If the employer accomplished the same result by taking the more circuitous route of contributing cash to the trust fund with which the trust fund purchased the employer stock, the necessary Internal Revenue Service approval would require a great deal of administrative time and expense, if indeed it could be obtained at all. Thus, in the realm of prohibited transactions an employer may be able to do directly what he cannot do indirectly.

The following considerations concerning contributions in kind relate to deductibility to the employer, valuation, and the prohibited transactions pitfalls.

A. *Real Property of the Employer*

1. *Deductibility.* An employer may make a tax deductible contribution of its real property instead of cash to a qualified plan⁵² to satisfy the employer's contribution requirements under the plan. The deduction is based on the fair market value of the property at the date of contribution.

2. *Valuation.* The fair market value of the property contributed to the qualified plan must be determinable. Normally, the employer will realize a gain or loss on the difference between the cost of the property to the employer and its fair market value at the date of contribution. Any gain is taxable to the employer on the theory of "economic gain,"⁵³ and will usually be a capital gain. Any loss realized by the employer cannot be recognized because of his relationship as grantor under the trust.⁵⁴ The

51. INT. REV. CODE of 1954, §§ 512, 513, 514.

52. *Colorado Nat'l. Bank v. Comm'r*, 30 T.C. 933 (1958); *Comm'r acquiesced*, 1959-1 CUM. BULL. 3.

53. INT. REV. CODE of 1954, § 1001(a)(b); *U.S. v. Gen. Shoe Corp.*, 282 F.2d 9 (6th Cir. 1960), 60-2 U.S. Tax Cas. 9678. *See also* *Tasty Baking Co. v. U.S.*, 393 F.2d 993 (Ct. Cl. 1968), 68-1 U.S. Tax Cas. 9366.

54. INT. REV. CODE of 1954, § 267(a); Rev. Rul. 61-163, 1961-1 CUM. BULL. 58.

Commissioner's and Tax Court's denial of a taxpayer's recognition of a capital loss has been upheld by the Fourth Circuit Court of Appeals in *Dillard Paper Co. v. Comm'r.*,⁵⁵ although the Court noted that it was ruling in a shadowy area. This decision indicates that if the property to be contributed in kind would result in a loss, it should not be contributed but sold to a third party and the proceeds contributed.

3. *Prohibited Transactions.* A valuation of contributions of real property (or other property) to a qualified plan must be accurate. If it is not accurate, the claimed deduction may be disallowed and charges made that the contribution was a "prohibited transaction," particularly if the property contributed is claimed as a deduction at a price higher than its actual fair market value. Such an accusation could be sustained on the basis that the trust has, in effect, purchased property from the employer for more than an adequate consideration.⁵⁶ Conversely, a valuation of contributions in real property, and a claimed deduction, at an amount lower than actual fair market value may be the basis of charges that the employer is trying to contribute more than the maximum allowable deduction and concurrently avoid capital gains tax.⁵⁷

B. *Stock of the Employer.*

1. *Deductibility.* The rules set forth above with respect to real property apply equally to deductibility when an employer's own stock is contributed to its qualified trust. The amount of the deduction is based upon the fair market value of the stock at the date of contribution.

2. *Valuation.* The rules applicable to valuation of real property apply to employer stock, except that a corporation cannot recognize either capital gain or loss to itself on the receipt of "money or other property" in exchange for stock, including treasury stock, of the corporation.⁵⁸ Since the employees' services would be construed as "money or other property,"⁵⁹ an employer would be deemed to have received the services of the employees in exchange for the contributed stock.

3. *Prohibited Transactions.* It can be argued that a contribution in employer stock has the same effect as a cash contribu-

55. 341 F.2d 897 (4th Cir. 1965), 65-1 U.S. Tax. Cas. 9267.

56. INT. REV. CODE of 1954, § 503(b)(4); Rev. Rul. 69-421, 1969-1 CUM. BULL. 59.

57. Rev. Rul. 71-311, 1971 INT. REV. BULL. No. 29, at 86.

58. INT. REV. CODE of 1954, § 1032.

59. 26 C.F.R. § 1.1032-1(a) (Supp. 1971).

tion to the trust fund used to purchase employer stock from the employer. This position, however, has not yet been advanced by the Internal Revenue Service, apparently because, applying a narrow literal interpretation of the definition of a prohibited transaction,⁶⁰ the trust fund has not in fact purchased the stock from the employer.

C. *Promissory Notes of the Employer.*

1. *Deductibility and Valuation.*

a. *Demand notes.* When a solvent accrual-basis employer contributes a demand promissory note to a qualified trust, the employer is clearly entitled to a tax deduction if there is no doubt as to its value at the date of delivery.⁶¹

b. *Term notes.* If an employer enjoys litigation it can make its contribution in the form of a term promissory note. The Internal Revenue Service takes the position that contributions to a qualified trust in such form are not deductible. This position has been upheld by the Tax Court in the case of *Wasatch Chem. Co. v. Comm'r.*,⁶² in which an unsecured, interest-bearing, five-year term note was contributed by a solvent employer to a qualified trust. The Tenth Circuit Court of Appeals disagreed with the Tax Court and held that the contribution was deductible. The fact that it was a term note was said to be relevant only to the value, and thus the deductible amount, of the contribution.⁶³ This decision was followed in a U.S. District Court decision, *Steel Wholesale Builders Supply Co. v. U.S.*,⁶⁴ which determined that certain term notes had a fair market value equal to their face value. The Internal Revenue Service, however, has decided not to follow the *Wasatch Chemical* decision of the Tenth Circuit Court of Appeals.⁶⁵ This leaves taxpayers in the unenviable position customarily associated with such a dichotomy.

2. *Prohibited Transactions.* If an employer's promissory note, adequately secured and bearing reasonable interest, is contributed to the qualified trust fund, there should be no problem in the prohibited transactions area.⁶⁶ However, an unsecured

60. INT. REV. CODE of 1954, § 503(b); Rev. Rul. 69-421, 1969-2 CUM. BULL. 59.

61. *Sachs v. Comm'r*, 208 F.2d 313 (3d Cir. 1953), 53-2 U.S. Tax. Cas. 9634; *Time Oil Co. v. Comm'r*, 258 F.2d 237 (9th Cir. 1958), 58-2 U.S. Tax Cas. 9769.

62. 37 T.C. 817 (1962).

63. *Wasatch Chem. Co. v. Comm'r*, 313 F.2d 843 (10th Cir. 1963), 63-1 U.S. Tax Cas. 9305.

64. 226 F. Supp. 82 (D.C. Tex. 1963), 64-1 U.S. Tax Cas. 9142.

65. Rev. Rul. 71-95, 1971 INT. REV. BULL. No. 8, at 15.

66. See notes 1.32, 36, *supra*.

note, especially a term note, which is contributed to the trust fund may be treated as if it were a loan to the employer, merely evidenced by an unsecured promissory note. This would constitute a prohibited transaction, and a strong argument can be made that the tax exempt status of the qualified trust fund could be jeopardized by such a transaction. The Tax Court in *Van Products Inc. v. Comm'r.*,⁶⁷ held that after enactment of the 1954 Code, loans by a profit-sharing trust to a solvent employer on the basis of unsecured, interest-bearing, term promissory notes were made without adequate security and thus constituted prohibited transactions. Earlier court cases, such as *Sachs v. Comm'r.*⁶⁸ and *Time Oil v. Comm'r.*⁶⁹ were decided under the 1939 Code, which did not contain the restrictions imposed by Section 503 of the 1954 Code. The Tax Court in the *Wasatch Chem. Co. v. Comm'r.* case⁷⁰ decided the case under the 1954 Code on the issue of the deductibility of the contribution, apparently without any consideration of the qualification and exemption aspects. The Tax Court in the *Van Products* case distinguished the *Wasatch* decision on the basis of dissimilar issues, and declared that unsecured promissory notes were not, in and of themselves, to be considered adequate security.⁷¹ Extreme caution in this area seems most advisable.

V. CHECK LIST BEFORE INVESTMENT OF TRUST FUNDS IN TRANSACTIONS INVOLVING THE EMPLOYER

A. *Attorneys' Examination.* Investments of the type falling within the "prohibited transactions" area should be thoroughly examined by legal counsel for the trust and for the employer before they are made. Counsel should consider, *inter alia*, whether the investment is permissible under the provisions of the plan and trust and the requirements of local law, the procedures to be followed, details of the transaction, and the registration or notification requirements of the Federal Securities Act of 1933⁷² and applicable State "Blue Sky" laws.

1. *Internal Revenue Service Requirements.* In establishing employee benefit plans, the employer's attorneys should handle all legal details from the inception of planning through the decision-making process, establishment of the program, initial and con-

67. 40 T.C. 1018 (1963). Cf. Rev. Rul. 70-131, 1970-1 CUM. BULL. 135.

68. 208 F.2d 313 (3d Cir. 1953).

69. 258 F.2d 237 (9th Cir. 1958).

70. 37 T.C. 817 (1962); *aff'd*, 313 F.2d 843 (10th Cir. 1963), 63-1 U.S. Tax Cas. 9305.

71. *Van Products, Inc. v. Comm'r.*, 40 T.C. 1018 (1963).

72. Securities Act of 1933, 84 Stat. 929, 15 U.S.C. § 77a-11 (1970).

tinuing qualification with the Internal Revenue Service, communication of the plan to the employees, and the continuing day-to-day interpretation and administration of the program. The "prohibited transaction" problems will be among the more difficult ones the attorneys must face. Because of the complexity of the technical details, the attorneys will usually demand and expect the full cooperation of and work closely with the employer's management, actuaries, accountants, investment advisors, trustees and insurance companies.

2. *Securities and Exchange and Blue Sky Requirements.*

It is especially important in situations involving investments in employer securities for legal counsel to explore thoroughly the federal and State registration and notification requirements.

a. *Federal Securities Act of 1933.* Securities and Exchange Commission (hereafter called the S.E.C.) officials usually take no action (require no registration or notification) and invoke no penalties if employees do not contribute to a plan, or if there is compulsory employee participation and contributions as a condition of employment, whether or not employer stock is used as an investment.⁷³ Usually, these officials take the position that a plan must be registered if there are voluntary contributions and an investment in employer securities in excess of the employer's contributions, or if the employees can direct investment of their own contributions in employer securities.⁷⁴ For many years the S.E.C. has considered requiring registration of any plan to which an employee contributes, voluntary or otherwise, on the theory that either the plan or the employees' accounts or interests in the plan constitutes issuance of securities by the plan or by the employer.⁷⁵ In each case legal counsel must consider registration requirements and such matters as available exemptions, if any, and the type and extent of registration or notification if required.

b. *"Blue Sky" Laws.* Counsel must also determine whether any "Blue Sky" laws of the states are involved. Many states have statutes requiring some type of registration, notification, or licensing in situations involving employee benefit plans, especially when plan funds are invested in employer securities.

3. *Other Laws.* Legal counsel must also consider the effect on contemplated transactions or provisions of administrative and regulatory laws, such as state banking and insurance laws (e.g., in New York State), federal and state disclosure laws (e.g.,

73. 2 P-H 1965 PENSION & PROFIT-SHARING ¶ 11,941 (1962).

74. *Id.*

75. *Id.*

California and Wisconsin), bonding provisions, labor laws, and wage-hour laws.

B. Internal Revenue Service Approval. Investments should not be made prior to the receipt of favorable advance rulings from the Internal Revenue Service if the investment involved is one in which advance rulings can be obtained, unless counsel is of the opinion that there will be no violation of the provisions of the Code which could cause the trust to lose its qualified status.

1. *District Director's Office.* In cases involving purchase of stock or secured loans (e.g., mortgages or debentures), details of the transaction should be submitted by the trustee (or in some cases, by the employer) to the District Director of Internal Revenue, in the manner set forth in Revenue Procedure 72-6⁷⁶ accompanied by the information therein required, with a request for a favorable advance determination letter. In cases involving "sales-and-lease-backs" and rental transactions it is apparently not possible at present to request an advance determination or ruling.⁷⁷

2. *National Office.* If a favorable determination letter is issued on the local level by the District Director:

In cases involving purchase of listed stock, if the stock is to be purchased on the open market or from the employer or others at the market price, usually no request for a ruling is made to the National Office of the I.R.S. as to the fair market value.

In cases involving purchase of unlisted stock, it is apparently not possible at present to request an advance ruling from the National Office as to the fair market value.⁷⁸

In cases involving secured loans where the type of collateral or security meets the requirements of Revenue Procedure 72-6, Section 8.02, the transaction may be submitted to the National Office for a ruling as to the adequacy of the collateral or security, as indicated in Revenue Procedure 72-6, Section 8.⁷⁹

In cases involving secured loans where the type of the collateral or security does not meet the requirements of Revenue Procedure 72-6, Section 8.02, it is apparently not possible at present to request a National Office advance ruling as to adequacy.⁸⁰

76. Rev. Proc. 72-6, § 4.03, 1972 INT. REV. BULL. No. 1, at 21.

77. Rev. Proc. 72-6, § 8, 1972 INT. REV. BULL. No. 1, at 23.

78. Rev. Rul. 71-311, 1971 INT. REV. BULL. No. 29, at 86.

79. "Where the adequacy of the security for a loan is involved, a ruling may be issued, but only if there is a clear indication of value which can be established by reference to recognized sources" Rev. Proc. 72-6, § 8.02, 1972 INT. REV. BULL. No. 1, at 23.

80. Rev. Proc. 72-6, § 8, 1972 INT. REV. BULL. No. 1, at 23.

Revenue Procedures 72-6⁸¹ and 72-2⁸² deal with the procedures involved in issuing notification letters and granting conferences by the National Office of the Internal Revenue Service with respect to cases in the prohibited transaction area. Revenue Procedure 72-6 indicates that if the transaction in question is an intentional violation of the rule that the investments of the trust be made for the "exclusive benefit" of the employees and involves a substantial part of the corpus, the trust loses its exempt status immediately, retroactive to the beginning of the year the violation commenced, and no notice of such loss is required. If the violation is not clear, the organization involved will lose its exempt status as of the first of the taxable year after the letter of notification, and will be given an opportunity to appear and defend the transaction.⁸³

VI. CONCLUSION

Investments of qualified employee benefit plan funds in the employer's stock, promissory notes, or other property should be made only after careful consideration and with extreme caution, in order to avoid problems with the Internal Revenue Service. If trust funds are to be invested in the employer's stock or other property, most trustees desire the additional protection of specific authorization in the trust agreement. The authorization may be accomplished either by designating a specific amount or limits, or by authorization from a committee or the employer. Careful consideration of the Internal Revenue Service rules will help to make investments which might otherwise fall into the area of prohibited transactions beneficial both to the employees and the employer.

81. Rev. Proc. 72-6, §§ 8.03-.09, 1972 INT. REV. BULL. No. 1, at 23-24.

82. Rev. Proc. 72-2, 1972 INT. REV. BULL. No. 1, at 5.

83. Rev. Proc. 72-6, § 8, 1972 INT. REV. BULL. No. 1, at 23.